

Edgar Filing: PREFERRED INCOME FUND INC - Form N-30B-2

PREFERRED INCOME FUND INC

Form N-30B-2

October 27, 2004

FLAHERTY & CRUMRINE PREFERRED INCOME FUND

Dear Shareholder:

The Flaherty & Crumrine Preferred Income Fund ("PFD") got off to a very good start in fiscal 2004. The total return on net asset value ("NAV") for fiscal first quarter ending February 29th was +5.4% 1. For the trailing twelve month period, the total return was +21.1% 1.

Once again, strength in the preferred securities market was the major factor in the Fund's performance. With interest rates hovering near all-time lows, individual investors have increasingly turned to preferred securities as they try to increase the income from their portfolios. At the same time, the size of the market has remained fairly stable. There has been a steady stream of new issues brought to market, but older issues are being redeemed at about the same pace. As expected, issuers are replacing older high coupon preferred issues with similar but less expensive ones.

These refinancing transactions are very important to the Fund--if the trend persists for a long period of time, there may be downward pressure on the income generated by the portfolio. On the other hand, low interest rates keep the cost of the Fund's leverage extremely low. So far these two effects have roughly offset each other.

The Fund's hedging strategy also performed as expected. To refresh your memory, PFD normally hedges by purchasing put options on U.S. Treasury bond futures. As interest rates go up or down, the prices of these put options typically move in the opposite direction of the preferred securities. There is, however, an important and valuable feature to a put option hedge--in a period of falling interest rates (as in recent months), the value of the preferred portfolio usually goes up by more than the drop in the value of the put options. Although the value of the hedge positions declined during the period, when compared to appreciation in the preferred positions this loss was small. Of course, if we knew interest rates were going to fall, the best hedge would have been no hedge at all, but our crystal ball is a bit too cloudy for that! We prefer to hedge consistently, knowing that the portfolio should participate in a rally but be protected if interest rates rise significantly.

The Fund's combination of preferred securities and the put option hedge creates an unusual investment product and we have yet to find a perfect benchmark for comparison. When measured against LONG-TERM fixed income investments, we expect the returns on NAV to lag (but generally only a little!) during periods of falling interest rates (because the hedge will hurt returns), and to perform much better if rates rise substantially. In most interest rate scenarios, the Fund's returns on NAV should out-perform SHORT-TERM investments, although the Fund's returns on NAV may lag briefly during periods of rising short-term rates. In any event, investors should always bear in mind that changes in the Fund's premium or discount to NAV can significantly affect the performance and volatility of the Fund's common share price.

To provide some comparison of the Fund's performance, the total return on the Lehman Brothers index of long-term investment grade corporate bonds (a good proxy for long-term fixed-income investments) was +4.9% during the fiscal quarter and +10.8% during the twelve months ending February 29th. The Lehman Brothers index of 3 - 6 month U.S. Treasury Bills (a short-term proxy) earned 0.3% during the quarter and 1.2% for the year. Keep in mind that these indices do not utilize leverage.

Economic conditions in the United States continue to show signs of improvement. This rising economic tide has benefited corporate profitability and enabled companies to improve the quality of their balance sheets. At the same time, sluggish job formation and subdued inflation have persuaded the Federal Reserve to keep monetary policy accommodative, which has held down the cost of the Fund's leverage.

In the coming weeks, the Fund's adviser, Flaherty & Crumrine, will launch a new web site, WWW.PREFERREDSTOCKGUIDE.COM. The site will contain useful

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information about most of the issues that make up the preferred securities universe. We've tried to make the site informative and easy to use. We hope you will also continue to visit the Fund's web site at WWW.PREFERREDINCOME.COM.

Sincerely,

/S/DONALD F. CRUMRINE

/S/ROBERT M. ETTINGER

Donald F. Crumrine
Chairman of the Board

Robert M. Ettinger
President

April 12, 2004

(1) Based on monthly data provided by Lipper Inc. Distributions are assumed to be reinvested at NAV in accordance with Lipper's practice.

Flaherty & Crumrine Preferred Income Fund
SUMMARY OF INVESTMENTS
FEBRUARY 29, 2004 (UNAUDITED)

	VALUE (000'S) -----
ADJUSTABLE RATE PREFERRED SECURITIES	
Utilities	\$ 38
Banking	20,99

TOTAL ADJUSTABLE RATE	21,37

FIXED RATE PREFERRED SECURITIES	
Utilities	92,39
Banking	52,18
Financial Services	24,63
Insurance	22,28
Oil and Gas	9,11
Miscellaneous Industries	4,21

TOTAL FIXED RATE	204,82

INVERSE FLOATING RATE PREFERRED SECURITIES	2,13
TOTAL PREFERRED STOCKS AND SECURITIES	228,32
CORPORATE DEBT SECURITIES	3,22
COMMON STOCKS AND CONVERTIBLE SECURITIES	9,31
PURCHASED PUT OPTIONS	78
MONEY MARKET FUNDS	3,61

TOTAL INVESTMENTS	245,25
OTHER ASSETS AND LIABILITIES (NET)	1,62

TOTAL NET ASSETS AVAILABLE TO COMMON AND PREFERRED STOCK	\$246,88
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FINANCIAL DATA
PER SHARE OF COMMON STOCK (UNAUDITED)

	DIVIDEND PAID	NET ASSET VALUE	NYSE CLOSING PRICE
December 31, 2003 - Extra	\$0.0400	\$15.90	\$18.40
December 31, 2003	0.0950	15.90	18.40
January 31, 2004	0.0950	16.23	18.35
February 29, 2004	0.0950	16.37	18.97

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STATEMENT OF CHANGES IN NET ASSETS AVAILABLE TO COMMON STOCK(1)
THREE MONTHS ENDED FEBRUARY 29, 2004 (UNAUDITED)

OPERATIONS:

Net investment income
 Net realized gain on investments sold during the period
 Change in net unrealized appreciation of investments held during the period
 Distributions to Money Market Cumulative PreferredTM Stock Shareholders from net investment
 income, including changes in accumulated undeclared distributions
 Net increase in net assets from operations

DISTRIBUTIONS:

Distributions paid from net investment income to Common Stock Shareholders (2)
 Distributions paid from net realized capital gains to Common Stock Shareholders
 Total Distributions

FUND SHARES TRANSACTIONS:

Increase from Common Stock Transactions

NET INCREASE IN NET ASSETS AVAILABLE TO COMMON STOCK FOR THE PERIOD

NET ASSETS AVAILABLE TO COMMON STOCK:

Beginning of period
 End of period

THREE MONTHS ENDED FEBRUARY 29, 2004
FOR A COMMON SHARE OUTSTANDING

PER SHARE OPERATING PERFORMANCE:

Net asset value, beginning of period

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INVESTMENT OPERATIONS:

Net investment income
Net realized gain and unrealized appreciation on investments

DISTRIBUTIONS TO MMP (R)* SHAREHOLDERS:

From net investment income (including change in accumulated undeclared dividends on MMP (R)*)
From net realized capital gains

Total from investment operations

DISTRIBUTIONS TO COMMON STOCK SHAREHOLDERS:

From net investment income
From net realized capital gains

Total distributions to Common Shareholders

Net asset value, end of period

Market value, end of period

Common shares outstanding, end of period

RATIOS TO AVERAGE NET ASSETS AVAILABLE TO COMMON STOCK SHAREHOLDERS:

Net investment income +
Operating expenses

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DIRECTORS

Martin Brody
Donald F. Crumrine, CFA
Robert M. Ettinger, CFA
David Gale
Morgan Gust
Robert F. Wulf, CFA

OFFICERS

Donald F. Crumrine, CFA
Chairman of the Board
and Chief Executive Officer
Robert M. Ettinger, CFA
President
Peter C. Stimes, CFA
Chief Financial and Accounting
Officer, Vice President
and Treasurer
R. Eric Chadwick, CFA
Vice President and Secretary
Bradford S. Stone
Vice President

INVESTMENT ADVISER

Flaherty & Crumrine Incorporated
e-mail: flaherty@fin-mail.com

QUESTIONS CONCERNING YOUR SHARES OF FLAHERTY & CRUMRINE PREFERRED INCOME FUND?

- o If your shares are held in a brokerage Account, contact your broker.
- o If you have physical possession of your shares in certificate form, contact the Fund's Transfer

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THIS REPORT IS SENT TO SHAREHOLDERS OF FLAHERTY & CRUMRINE PREFERRED INCOME FUND INCORPORATED FOR THEIR INFORMATION. IT IS NOT A PROSPECTUS, CIRCULAR OR REPRESENTATION INTENDED FOR USE IN THE PURCHASE OR SALE OF SHARES OF THE FUND OR OF ANY SECURITIES MENTIONED IN THIS REPORT.

[GRAPHIC OMITTED]
LIGHTHOUSE

Flaherty & Crumrine
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PREFERRED INCOME Fund

QUARTERLY
REPORT

FEBRUARY 29, 2004

web site: www.preferredincome.com